DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0186
Corporate Income Tax
For Tax Year 2002

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. **Corporate Income Tax—**Capital Contributions

Authority: IC § 6-2.1-1-2; IC § 6-8.1-10-2.1; *United States v. Chicago, Burlington & Quincy R. Co.*, 412 U.S. 401 (1973); *Brown Shoe Co., Inc. v. Commissioner*, 339 U.S. 583 (1950); *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943); *First National Bank of Richmond v. Turner*, 154 Ind. 456, 461-62, 57 N.E. 110, 112-113 (1890); *Hamilton Airport Advertising v. Hamilton*, 462 N.E.2d 228, 238 (Ind. Ct. App. 1984); I.R.C. § 118; I.R.C. § 362

Taxpayer protests the assessment of gross income tax and adjusted gross income tax with respect to certain payments that Taxpayer maintains were third-party capital contributions.

STATEMENT OF FACTS

Taxpayer is a corporation created to engage in a variety of economic and community development projects. Business' parent company also owned Taxpayer. However, Business eventually transferred ownership to three of its owners in 1999.

As part of an agreement between Business and City, Taxpayer received a portion of Business' adjusted gross receipts. According to Taxpayer's protest, Taxpayer used the funds that it received to further its corporate purposes for community development, with Business receiving no direct benefit.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer. The Department assessed Taxpayer gross income tax, adjusted gross income tax (actually a reduction in net operating losses permitted to be used in future years), and penalty on the assessment. Taxpayer protested the assessment. The Department conducted a hearing on the protest and this Letter of Findings results. Additional facts will be supplied as necessary.

I. **<u>Corporate Income Tax</u>—**Capital Contributions

DISCUSSION

Taxpayer's contention is that the amounts that Taxpayer received from Business constituted third-party capital contributions. Taxpayer argues that it treated the payments as paid-in capital excluded from income for federal tax purposes and that the same treatment should be afforded those payments under Indiana gross income tax and adjusted gross income tax laws.

Prior to repeal in 2003, IC § 6-2.1-1-2 provided that, "Except as expressly provided in 'gross income' means all gross receipts a taxpayer receives: [list of ten sources]." In addition to nine specifically listed items, IC § 6-2.1-1-2(a)(10) provides that gross income includes receipts "from any other source not specifically described in this subsection."

On of the exceptions to gross income is IC § 6-2.1-1-2(c)(14), which provided that gross income does not include "the receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to the capital thereof ."

In Indiana, the term "capital" is defined by our case law as follows:

> When used with respect to the property of a corporation or association the term has a settled meaning; it applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed . . . .

First National Bank of Richmond v. Turner, 154 Ind. 456, 461-62, 57 N.E. 110, 112-113 (1890) (citing *Bailey v. Clark*, 88 U.S. 284 (1874)). This definition has not been altered in Indiana case law to negate that capital must be contributed by stockholders. *See Hamilton Airport Advertising v. Hamilton*, 462 N.E.2d 228, 238 (Ind. Ct. App. 1984). The common meaning of "capital contribution" is "1. Cash, property, or services contributed by partners to a partnership. 2. Funds made available by a shareholder, usu. without an increase in stock holdings." Black's Law Dictionary 201 (7th ed. 1999).

Ordinarily, shareholders make capital contributions to corporations, as opposed to non-shareholders. However, the issue of whether a non-shareholder (i.e., Business) *can* make a payment to a corporation that qualifies as a capital contribution remains.

The argument that non-partners and non-shareholders may contribute capital to a corporation is supported by *Brown Shoe Co., Inc. v. Commissioner*, 339 U.S. 583 (1950). In *Brown Shoe*, local communities provided cash contributions as incentives to a manufacturer to locate in their towns. The Court held that the cash contributions were "'contributions to capital' within the meaning of [1939 Internal Revenue Code] Sec. 113(a)(8)(B) [(now Sec. 362(a))]," and were therefore entitled to be depreciated. *Id*. at 589; *see also* I.R.C. § 362(c). The holding in *Brown Shoe* which recognized that non-shareholders could make contributions to capital was narrowed by the

Court to those instances where there were neither customers nor payments for services. *Brown Shoe*, 339 U.S. at 589. The Court in *Brown Shoe* stated that:

> The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under those circumstances, the transfers manifested a definite purpose to enlarge the working capital of the company. *Id*. at 591.

In reaching its decision, the Court in *Brown Shoe* distinguished the case before it from the earlier case of *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943). In so doing, the Court stated that:

> [The *Detroit Edison*] decision denied inclusion in the base for depreciation of electric power lines the amount of payments received by the electric company for construction of the line extensions to the premises of applicants for service. It was held that to the extent of such payments the electric lines did not have cost to the taxpayer, and that such payments were neither gifts nor contributions to the taxpayer's capital. *Brown Shoe*, 339 U.S. at 591.

In *Detroit Edison*, "[t]he payments were to the customer the price of the service [provided by taxpayer.]" *Detroit Edison*, 319 U.S. at 103. Therefore, the Court concluded, "it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company." *Id*. at 102.

The Court in *United States v. Chicago, Burlington & Quincy R. Co.,* 412 U.S. 401 (1973), summarizes the distinctions made by *Detroit Edison* and *Brown Shoe* with regard to whether non-shareholders can remit monies to corporations as contributions to capital.

> Where the facts were such that the transferors could not be regarded as having intended to make contributions to the corporation, as in *Detroit Edison*, the assets transferred were not depreciable. But where the transfers were made with the purpose, not of receiving direct service or recompense, but only of obtaining advantage for the general community, as in *Brown Shoe,* the result was a contribution to capital.

Chicago, Burlington, 412 U.S. at 411.

> We can distill from these two cases [*Detroit Edison* and *Brown Shoe*] some of the characteristics of a non-shareholder contributor to capital under the Internal Revenue Codes. It certainly must become a permanent part of the transferee's working capital structure. It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. It must be bargained for. The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value. And the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Id. at 413.

Taxpayer was created to assist in the economic development of City by providing low-income housing and other community development projects. For a time, Taxpayer provided that assistance. However, Taxpayer has not provided evidence that it assisted City in its economic development in recent years. The payments from Business to Taxpayer were not "capital contributions" to assist City's economic development. Therefore, Taxpayer's protest is denied for both gross income tax and adjusted gross income tax.

Taxpayer also protests the imposition of a negligence penalty. Taxpayer has not provided sufficient information to justify waiver of penalty.

FINDING

Taxpayer's protest is denied.

JR/BK/DK–July 2, 2007